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July 26, 1996

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

Mr. William Caton
Acting Secretary
Federal Communications Commission
1919 M Street, N.W., Room 222
Washington, D.C. 20554

DOCKET FILE COPY ORIGINAL

Re: CC Docket No. 96-98

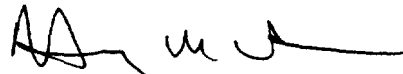
Dear Mr. Caton:

I have today provided copies of the attached document to the following:

James L. Casserly, Senior Legal Advisor to Commissioner Ness;
John Nakahata, Senior Legal Advisor to the Chairman;
Dan Gonzalez, Legal Advisor to Commissioner Chong;
Regina Keeney, Chief, Common Carrier Bureau; and
Joseph Ferrell, Chief Economist, FCC.

It had been requested previously by Commissioner Quello's office and a copy was filed with your office on July 18, 1996 in response to that request.

Sincerely,



Harry M. Shooshan

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Enclosure

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The Role of Resale in Establishing Local Competition

Harry M. Shooshan III and John Haring

Harry M. Shooshan III and John Haring are principals in Strategic Policy Research, Inc., an economics and telecommunications policy consulting firm located in Bethesda, Maryland. Mr. Shooshan formerly served as Chief Counsel and Staff Director for what is now the Subcommittee on Telecommunications, U.S. House of Representatives. Dr. Haring formerly served as Chief Economist and Chief, Office of Plans and Policy, at the FCC.

Resale of local service offerings is one of the principal means for opening local telephone markets to competition contemplated by Congress in the Telecommunications Act of 1996 ("Act"). Along with imposing the duty to interconnect and to unbundle network elements, the Act prohibits unreasonable or discriminatory restrictions on resale and requires incumbent local exchange carriers ("ILECs") to resell at wholesale rates any telecommunications service that they offer at retail. Resale policy is thus one of three basic policy legs supporting the stool on which Congress' expectations for local competition rest.

Establishing facilities-based local competition is the primary objective of the new Act. For example, the Act's essential *quid pro quo* for Bell Company provision of in-region interLATA service is the presence of a *facilities-based* competitor. The Act requires that competing providers offer telephone exchange service "over their own telephone exchange facilities or predominantly over their own . . . facilities in combination with the resale of the telecommunications services of another carrier."

In Congress' conception, resale policy should *enable* facilities-based competition rather than supplant it. The primary goal of the Act is to encourage efficient competitors to deploy competing networks as a means of securing the benefits of competition. The fact that virtually all major existing facilities-based competitors (ILECs, CLECs and cable companies) have opposed deep discounts for resale of local service suggests the need for a carefully calibrated resale policy if facilities-

based competition is to develop.

The Intent of Congress

In establishing guidelines for implementation of the Act's resale requirements, Congress sought to strike a balance between the interests of new entrants and ILECs. The Act established broadly-defined rights to resell ILEC retail offerings. At the same time, it requires that wholesale rates for resale offerings be established at levels that recover relevant costs. Congress adopted the avoided cost standard as a means of enabling resale, while not unfairly burdening facilities-based competitors. The standard operates as a limit on the amount of discount embodied in wholesale offerings.

The Act requires that all local exchange carriers make available their telecommunication services for resale without unreasonable or discriminatory restrictions. It further requires ILECs to establish wholesale rates for *any* service which they offer at retail to end-user (noncarrier) customers and it specifically establishes a basis for calculation of wholesale rates.

Retail rates supply the starting point for establishing wholesale rates, even if those rates reflect socially-engineered pricing policies and are uneconomically low.¹ The wholesale price is to be set based on the marketing, billing and other costs that are *avoided* by the ILEC when a reseller sells the service. Thus, under the Act's provisions, wholesale rates are established by excluding avoided costs, *not* by determining what level of wholesale rates are necessary to ensure that any particular reseller earns enough money to remain economically viable. Some resellers may be more efficient than others and provide a more attractive complementary set of offerings. Some resellers may be prepared to invest in good will (perhaps entailing short-term losses) in order to sign up customers whom they plan to serve eventually over their own (more efficient) facilities. With wholesale rates set to reflect avoided costs, if a reseller were more efficient than an ILEC in undertaking marketing, billing, collection and other activities, it would be able to succeed. If a reseller were less efficient in meeting customer needs, nothing suggests that Congress meant for terms of

resale to guarantee success in the marketplace.

Avoided costs are those the ILEC actually no longer incurs as a result of supplying a particular wholesale service, not a measure of what those costs "ought to be" or what they are in other sectors of the economy. It is, thus, irrelevant under Congress' standard what "discount," for example, is available to resellers in the long-distance market in which carriers typically incur higher costs of marketing and promotion and where volume-discounted rather than wholesale offerings supply the basis for resale. Setting the discount based on observations of large retail markups (up to 100 percent) elsewhere in the general economy is similarly inapt. Since local exchange service has been, and still largely is, a monopoly service, it is not intensively marketed and promoted in the way that clothing, fast food and compact discs are. Relatedly, there have heretofore been no volume discounts for residence customers. Indeed, residence customers who want a number of phone lines are generally home-based businesses. Such businesses typically have been required to purchase business service which is priced at *higher* rates than basic residence service. Where business services are discounted (*i.e.*, Centrex), those discounts have typically formed the basis for resale of local service in those states that currently permit it.

There is often sentiment among regulators to use the regulatory process to handicap competition and competitors, based on a view that incumbents are big and bad while entrants are small and good. While ILECs are big ("800-pound gorillas"), new entrants in local telephony are hardly the "90-pound weaklings" they often portray themselves to be in order to exploit regulatory sensibilities. Many would-be local competitors possess very substantial resources and formidable supply capabilities. AT&T, for example, has switches in place that can be reprogrammed to handle local traffic and an extensive marketing organization. MCI Metro has access to valuable rights-of-way in the largest cities and is closely integrated with a major foreign ILEC (BT). Cable companies have infrastructure in place as well as an established relationship with residential customers (including billing systems).

Apart from their corporate lineage or existing position in the market, local competitors are free to deploy their networks selectively to maximize business opportunities. Our interviews with telecommunications users suggest that, in many cases, new entrants are able to secure business customers by configuring local networks and concentrating resources to comport with the strategic needs of those customers. Moreover, these networks typically use the "latest and greatest" technology and usually can be built and maintained

relatively cheaply when compared to the legacy networks of ILECs. In nearly every jurisdiction, the ILECs are faced with pricing constraints and service requirements that do not apply to the ILECs' competitors. Regulators obviously cannot ignore ILECs' established position in implementing the resale provision of new Act, but neither should they provide new entrants a "leg up" on the basis of unrealistic "infant industry" assumptions. The Act provides clear guidance about the "objective" basis to be utilized for setting wholesale rates.

Limited Relevance of Historical Precedent

FCC regulatory policies proscribing restrictions on resale originally grew out of concerns about undue discrimination in the pricing of long-distance service. From the FCC's perspective, tariff restrictions on resale operated to support AT&T's ability to discriminate unreasonably among different classes of users. The Commission was also concerned that AT&T could use excessive volume discounts (coupled with resale restrictions) to thwart competition. Regulation guaranteeing the right to resell volume-discounted long-distance service served to limit the offer of discounts not based on cost and to "democratize" the benefits of lower-priced offerings. By aggregating usage from smaller users, resellers could offer price cuts to customers who, based on their individual usage levels, would not have otherwise qualified for the discounts.

The FCC decision to require AT&T to remove resale restrictions on its services created a new industry. Today, there are several hundred long-distance resellers which buy service under long-distance carriers' bulk discount tariffs and resell primarily to mid-sized and small customers. In addition, facilities-based long-distance carriers (*viz.*, Sprint and MCI) were initially able to use resale to "fill in" their networks on routes where their own traffic volume did not justify the construction of separate network facilities.

While long-distance resale policy is frequently invoked in the debate about the local-service resale, it was largely motivated by different concerns than those which motivate local resale policy. The FCC's long-distance resale policy was designed to limit price discrimination; the new local policy *requires* (cost-based) price discrimination to promote competition. Resale policy originally served to check the incumbent's ability to reduce price and deter competition, while local-resale policy envisions incumbents reducing their prices to benefit competitors directly. While long-distance resale entailed repackaging volume-discounted retail offerings established by the carriers, local resale entails the repackaging of newly

created "wholesale" local offerings and, thus, goes well beyond simple resale as we have known it up to now.

Optimizing Tradeoffs

As local markets are opened, potential entrants will develop their entry strategies (*viz.*, whether to build or buy) based on the incentives they confront. Regulation to implement the Act's competitive provisions will profoundly affect the incentives and decisions of different market participants. Resale can serve as both a substitute and complement for facilities-based competition. Facilities-based competitors initially may need economically priced resale offerings to complete their networks. But if wholesale packages are priced at uneconomically low levels, deployment of new local network capacity will be discouraged. The pricing of wholesale offerings for resale thus poses a demanding task for regulators seeking to promote competition. If rates are set too high, competition may be inhibited because entrants are unable to offer an attractive (*i.e.*, "complete") service. If rates are set too low, facilities-based competition may be thwarted because investment in network facilities cannot compete with low-priced resale offerings.

Earlier we noted the role resale was historically viewed to play in preventing unreasonable price discrimination. Local resale poses an interesting twist on the effectiveness of resale in limiting discrimination. In the context of volume discounts, resale discourages the offer of excessive noncost-based discounts and thus limits unreasonable discrimination between heavy and light users. By the same token, resale may also limit the ability of *regulators* to maintain pricing schemes that discriminate on a noneconomic basis.

In many local venues, regulation to promote universal service has established rates for basic local services at low levels. ILECs have been able to maintain low rates by charging higher rates for other services. For example, many of the so-called vertical services that telephone companies provide (*viz.*, call waiting, call forwarding, *etc.*) are priced to generate contribution to offset the contribution foregone on basic service. Obviously terms and conditions governing resale have profound implications for the maintenance of these kinds of pricing regimes. If a reseller can purchase a basic service offering at a wholesale price reflecting avoided costs (*i.e.*, does *not* have to purchase the full slate of local offerings or the basic offering at a price that covers the foregone contribution on lost sales of the vertical services), the existing pricing schemes cannot remain viable. Resellers could take the discounted basic offering and couple it with vertical (and other) services of their own, which they can price

very competitively given the need for ILEC offerings to be priced to sustain low rates for basic offerings.²

In this type of situation, resale policy and regulatory pricing of basic service to promote universal service conflict. Something has to give. Resale undermines the basis for sustaining low rates. Unless resale of the whole slate of related offerings is required or wholesale rates cover the opportunity costs of foregone contribution on sales of vertical services, the low basic service rates must be raised. There is thus a potentially thorny issue to be addressed in implementing the Act. The more favorable the terms and conditions on resale, the faster and more completely must rates presumably adjust.

Optimal policy depends, *inter alia*, on conditions prevailing in different markets and the preferences of regulators in terms of the tradeoffs between benefits of resale and benefits of regulatory pricing. In some local venues required rate adjustments may be minimal and few problems posed by resale. In other localities, regulated rate structures may be highly inconsistent with rate structures consistent with effective competition. In these settings, the more regulators do to promote competition by adapting favorable terms and conditions for resale, the faster and greater will be the required adjustments in rates and the greater the presumed need for consumer consultation and education.

An unbalanced rate structure artificially stimulates competitive entry in market segments where rates are inflated and deters entry where rates are depressed. An economically efficient rate structure promotes *efficient* competition by supplying price signals which accurately disclose true supply capabilities and efficient performance benchmarks. Attempts to thwart resale and restrict rebalancing are inimical to efficient competition. Our view is that significant rate rebalancing is required and that flexibility to implement rebalancing should be promptly afforded. A policy that restricts rebalancing, but does not restrict resale is an incoherent policy. Resale will ultimately force rebalancing.

Establishing Wholesale Prices

There are, in principle, two ways to determine wholesale prices for resold local service. The first is what might be called the "bottom up" approach which would require establishing the actual cost of the wholesale service, including relevant opportunity costs. Congress chose a "top down" approach which calls for the use of current retail rates as a starting point for establishing wholesale rates. The Act requires retail prices to be adjusted by excluding "the portion thereof

attributable to . . . costs that will be avoided by the local exchange carrier.” This presents a difficult task for both companies and regulators especially since current prices for individual ILEC services often bear little or no relation to relevant costs and often presume an effective monopoly on service. In addition, there is an issue of how costs incurred specifically to supply resale offerings are to be recovered under the top-down approach. Cost-based pricing of wholesale offerings requires remuneration that reflects not only costs avoided, but any additional costs incurred in making a wholesale offering.

The challenge in setting appropriate levels for wholesale rates is to determine what portion of retail rates is attributable to costs that are avoided by making a wholesale offering to resellers. A wide range of estimates of the percentage of the retail price attributable to avoided costs have been offered.³ Avoided costs are likely to vary for a number of different reasons:

1. Avoided costs likely will vary with the volume of the purchase and the length of the term to which the reseller commits.
2. Avoided costs will likely vary by service. A uniform avoided-cost allocation is thus not likely to be appropriate.⁴ The FCC suggests that taking into account service-by-service variations may be “administratively complex.” Administrative complexity is often a cost of dealing effectively with a world that is not simple. Against the benefits of administrative simplicity must be weighed economic efficiency losses deriving from failures of prices to track costs or failure to compensate adequately for the failure of prices to track costs when divergencies are unavoidable. The FCC’s task obviously might not seem so daunting if it were to rely to a greater extent on private negotiations among interested parties and on state regulatory oversight, as it is, in fact, so directed by the Act.
3. Although we believe it can be inferred from the avoided cost standard in the Act, wholesale rates should presumptively include a reasonable return and should contribute to recovery of shared and common costs to the extent that the retail offering does so. If regulation restrains the extent to which rates can be rebalanced consistent with competition, opportunity costs of foregone contribution need to be recovered on wholesale rates for revenue neutrality⁵
4. If wholesale rates are to be cost-based, they need to reflect any costs incurred by ILECs to make specific resale offerings. For example, when a

customer calls a reseller to report a service problem, the reseller may have to contact the LEC in order to have the problem solved. In this case, while the LEC can fairly be said to have avoided the cost of dealing with an inquiry from the retail customer, it will also incur a cost to maintain the interface with the reseller.

Measuring avoided costs to determine wholesale prices for local service resale offerings is a key task for regulators under the methodology Congress has prescribed in the Act. It is fairly easy to identify the categories of costs that need to be considered to determine whether any, all or none are avoided when a service is offered for resale. A more difficult task involves determination of the degree to which costs within particular categories are avoided.

In addition to measurement of avoided costs, cost-based wholesale rates also require measurement of any costs specifically caused by making a particular resale offering. For example, ILECs may incur costs integrating a reseller’s systems with its own databases for service order and repairs. If inputs are not priced to recover their costs (in this case, wholesale offerings to resellers), the tendency will be to overuse those inputs (and undersupply them). If these costs are not recovered from resellers, they will have to be recovered from other ILEC customers or services cannot be supplied.

Costs incurred to supply wholesale offerings can be collected from resellers either by setting them off against the costs avoided, so that it is the “net” avoided costs that are offset against the retail price or by a direct charge paid by the reseller. Again, the net avoided costs or direct charge will presumably vary from service to service and according to the particular circumstances surrounding the transaction.

Arrangements for resale of local service in individual states have been evolving through negotiations among interested parties and as a result of decisions by various state commissions. There does not appear to be any compelling reason at this relatively early stage for the FCC to spend scarce resources creating a uniform national round hole into which every particular local or regional square peg must be forced. In any rules it eventually adopts, the FCC should allow for resale arrangements based on voluntary agreements among transacting parties. Where there are disputes, say over avoided costs, states are presumably better positioned to deal with those questions, given the peculiarities of each jurisdiction, than is the FCC. The FCC is also apparently highly resource-constrained and, consequently, is unlikely to be capable of fashioning customized fixes for particular sets of relevant circumstances.

Permitting Appropriate Restrictions

The Act requires all local exchange carriers to make telecommunications services available without "unreasonable or discriminatory conditions or limitations." Thus, any proposed restriction must be measured against this standard. The Act does specifically authorize state regulators to prohibit resale of a service that is available at retail to a particular category of subscribers to a *different* category of subscribers. States can, therefore, prohibit resellers from offering low-priced residence services to business customers *if* the residence service was obtained at wholesale rates. This leaves open the question of whether a reseller could be barred from reselling residence service to business customers if the residence service were obtained at retail rates (but again at a low level). A number of states have adopted local resale policies that bar *any* resale of residence service to business customers. As we have noted, such restrictions are necessary to sustain regulated pricing structures until such time as states permit ILECs to rebalance intrastate and local service rates. A policy of restrictions on rebalancing but no restrictions on resale embodies an incoherent conflict.

Under the Act, ILECs are required to allow resale of the services they offer at retail. ILECs are not required to offer subparts of offerings that consist of a bundle of capabilities, as long as the subcapabilities are not offered individually at retail. For example, basic local service consists of more than simply "dialtone" or local connection. It includes usage, operator support, directory assistance, billing and collection and long-distance access. While the Act requires the ILECs to allow resale of any services they offer at retail, it does not require ILECs to *create new* retail offerings. Where there are costs avoided in conjunction with the various elements of the package, those would be taken into account in setting the wholesale price, but the Act does not require the *retail* package itself to be disaggregated for resale purposes.

The FCC has raised the question of how discount and promotional offerings should be treated for purposes of meeting resale requirements under the Act. Discounts off retail prices are obviously common in the general economy as well as in competitive sectors of the telecommunications industry. So are *restrictions* on the availability of discounts. For example, on any given day, a local supermarket will offer discounts on a variety of products. Customers are generally restricted as to quantities that can be purchased at discount and often on what amounts to a "first-come, first-served" basis with no "rainchecks." The particular products discounted may also vary from locality to locality based

on valid business judgments. These types of restrictions are commonplace. Promotional pricing and trials are also used throughout the economy and typically play an important role in the introduction of new services. For example, many Internet information and software providers make introductory offers, often promising service "free-of-charge," as a means of inducing consumers to try their services.

The issue is not whether ILECs should be able to market in the same way, but under what terms and conditions discount and promotional tariffs are offered for resale. The appropriate treatment of discount and promotional offerings again poses a tradeoff issue for regulation. If ILECs are required to allow resale of promotions or trials on an unrestricted basis, they will be less likely to introduce new and innovative services or packages, and consumer welfare will be lessened on this score. The purpose of innovation and creative marketing is, after all, to gain at least a short-term competitive advantage. At the same time, there is a risk that the right to make special pricing offers and undertake new service trials on a restrictive basis could be systematically abused to evade the general resale requirement of the Act.

Our view is that this is an area where regulators may, at least to some extent, be able to eat their cake and still have it. Regulatory oversight of the terms and circumstances under which promotional pricing plans and new service trials are offered can limit risks of abuse. Many states already condition special offerings, for example, placing limits on the duration of promotional pricing plans or trials. Abuses may be subject to easy detection. If competitors believe promotional offerings are being utilized to circumvent resale requirements anticompetitively, they can challenge the offensive offerings. This is another area where FCC guidelines could help clarify what might constitute reasonable restrictions, leaving discretion to the states to intervene in particular circumstances.

With respect to the issue of whether discount offerings must themselves be further discounted for purposes of wholesaling, there appear to be several relevant considerations. Application of the avoided-cost methodology will obviously tend to produce smaller wholesale discounts to the extent that discount offerings already reflect significant resource cost savings. Matters are likely to become more complex where rough or average calculations of avoided costs do not accurately reflect actual amounts of avoided costs. Suppose regulators adopt rough rules-of-thumb for purposes of calculating avoided costs, as does not seem unlikely, and that such benchmarks overstate avoided costs for some offerings. ILECs are obviously

not going to be too happy making any offering available for resale at uneconomic rates, but they are probably particularly unlikely to want to make offerings that are already heavily discounted available for resale at even greater discounts on an unrestricted basis. In this circumstance, prohibiting or limiting restrictions is liable to discourage such offerings and a welfare tradeoff is posed for regulation.

Competition Policy in Context

As we observed at the outset, resale is one of three legs supporting the stool on which Congress' expectations for local competition rest. One of the themes we have emphasized is the need to set resale policies in relation to other competitive policies and goals lest the stool become unbalanced and Congress' expectations topple. In establishing the ground rules for local competition, policymakers need to keep in mind that regulated competition frequently represents the worst of both worlds. While regulation can play an important role in the transition to open, competitive local telecommunications markets, it should be conceived as a *transitional* role. Resale policy is one means to the end that the Act clearly envisions — telecommunications markets unfettered by either monopoly or regulation.

The same need for balance applies with respect to balancing competitive policies and goals with other statutory objectives. Competition is a means to an end. The Telecommunications Act of 1996 *did not amend* the goals of the Communications Act of 1934. The ultimate goals of telecommunications policy remain

... to make available, so far as possible, to all the people of the United States a rapid, efficient, Nation-wide, and world-wide wire and radio communication service with adequate facilities at reasonable charges, for the purpose of the national defense, for the purpose of promoting safety of life and property through the use of wire and radio communication

Just as an unbalanced approach to competition policies may not produce good results, so also may an unbalanced approach to reconciliation of competition policy with other regulatory goals and means produce poor results.

We think these ultimate goals may be threatened if regulators adopt an "all-you-can-eat" approach to implementation of local competition, that is, if regulators give each set of new entrants what those entrants want at the expense of the incumbents. Regulators may be tempted to give advocates of resale the deep discounts they are seeking, then to "balance"

that policy with an extremely favorable interconnection compensation scheme and extensive unbundling with prices based on incremental costs.⁶ Regulators may also choose to move slowly in affording ILECs adequate flexibility to rebalance rates so as to avoid possible political fallout and to maintain a price umbrella to protect new entrants from real competition. This outcome would not only be manifestly unfair to the ILECs and their shareholders, but could also undermine success in achieving the ultimate goals of telecommunications policy. Careful balancing is required to ensure that the terms of the transition are fair and consistent with the overall objectives of the Communications Act.

Bell Atlantic paid for some of the research for this paper. The views, however, are those of the authors.

Endnotes

1. In a number of states, ILECs are already making basic residential service available at wholesale rates which are typically 5%-10% below ILEC retail rates.
2. For those who choose to resell local service in conjunction with other offerings (e.g., long distance, wireless and video), resale provides the ability to offer a "one-stop" shop. The Act prohibits the largest long-distance carriers from jointly marketing resold local service (that it obtains from the local Bell company) and interLATA service for three years or until the Bell company has obtained the right to offer interLATA service, whichever comes first. There is, however, no comparable restriction on other local competitors.
3. For example, AT&T has argued for discounts of around 40 percent in a number of jurisdictions. Existing local resale rules or agreements typically embody discounts of between 5 and 18 percent which also vary depending on the type of service being resold.
4. Several states commissions have recognized this principle by adopting different discounts for business and residence services.
5. Any problems of excessive earnings should be dealt with directly.
6. Even with such "balance," overly generous terms and conditions for resale may all but preclude facilities-based competition.